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TORONTO...Some of the glue that holds Canada together as a nation is weakening, according to a special research report on Federal-Provincial Relations.

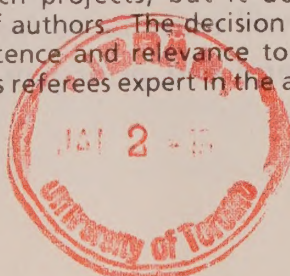
The study, prepared for the Ontario Economic Council, perceives the danger of the system of equalization payments unravelling, because of bilateral agreements between the federal government and the provinces, such as the Canada-Nova Scotia Offshore Energy Pact, and also because of a policy that discourages the eastern provinces from developing their energy sources.

***Equalization Payments: Past, Present and Future***, was written by Thomas Courchene, professor of economics at the University of Western Ontario, and Chairman of the Ontario Economic Council. The study includes a history of the country's equalization program and also covers some of the broader aspects of federal-provincial fiscal relations.

It evaluates the principles that have governed the equalization program, and suggests the prospects for the future.

Because of fairly recent developments, the author senses an urgent need for redesigning Canada's system of equalization payments. He believes the next renegotiations of the equalization and fiscal arrangements in 1987 will once again come face to face with a tension-ridden environment.

This report reflects the views of the author and not necessarily those of the Ontario Economic Council. The Council establishes policy questions to be investigated and commissions research projects, but it does not influence the conclusions or recommendations of authors. The decision to sponsor publication of this study was based on its competence and relevance to public policy and was made with the advice of anonymous referees expert in the area.





Among the many noteworthy features of Canada's new constitution is its enshrining, for the first time, of the principle of equalization.

'Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.'

He blames the high degree of politicization for eroding the general acceptance that Canada's equalization program has enjoyed up to now.

In particular, he is concerned about the latest equalization initiative – the agreement between Ottawa and Nova Scotia for sharing offshore revenues.

### ***Equalization and the Nova Scotia deal***

A deal has been struck between Nova Scotia and the federal government to shelter this province's offshore revenues from the impact of the equalization formula.

The legislation will override whatever equalization program happens to be in effect when the offshore revenues begin to flow in.

The amount of revenue involved is likely to be substantial, since Nova Scotia is guaranteed ALL revenues from offshore (except the federal corporate income tax collections) until the province's fiscal capacity exceeds 110 per cent of the national average. (This 110 per cent figure will be adjusted upward by 2 percentage points for every 1 percentage point that Nova Scotia's unemployment rate exceeds the national average level.)

The legislation effectively provides that Nova Scotia's equalization will be calculated by including only 10 per cent of offshore revenues in the formula in year one, 20 per cent in year two, and so on.

Professor Courchene calls this *an incredible piece of legislation*.

'It will surely undermine the high degree of general acceptance hitherto accorded to equalization in the federation. Other agreements of this type are sure to follow, and the net result will be that equalization will cease to be formula-based and it could well degenerate into a program determined principally by political and paternalistic considerations.'



The author believes the implications go well beyond this. He points out that the result of the 1982 fiscal arrangements was to pull back on established programs funding and to 'regionalize' equalization—that is, to shift equalization payments away from Manitoba and Quebec and toward the Atlantic region. He says this shift has in itself served to strain the overall relationship between vertical and horizontal balance in the federation.

'All of the four Atlantic Provinces ALREADY have access to overall revenues per capita (corrected for tax effort) in excess of those available to Manitoba, Quebec, and Ontario. Consequently, *to shelter a revenue increase in one of the Atlantic Provinces from the workings of the equalization program is to run the very serious risk of having equalization join the set of programs that generates regional tension rather than national unity. It seems to me that the way is now open for some province to take the overall equalization program (including the offshore deal) to the courts, on the grounds that it runs afoul of the new equalization provision of the constitution.*'

That's not the author's only concern about the Nova Scotia deal. He points out that Saskatchewan does not have access to ALL energy revenues (except the federal income tax) until it achieves a per capita fiscal capacity equal to 110 per cent of the national average.

He asks, 'Why should Nova Scotia be different?'

Professor Courchene continues, 'It seems to me that the Nova Scotia-Ottawa deal increases the urgency for redesigning the equalization program. Assuming that this offshore pact will override the existing equalization program, emphasis must be put on ensuring that the implications of such an agreement are minimized.'

The study concludes that this agreement has far-reaching implications for both equalization and the fiscal arrangements generally, and that if these agreements spread (as they surely must) the final result would be the replacement of a universal, formula-based approach to equalization by an approach that is determined principally by bilateral pacts between Ottawa and the several provinces.



### ***Canada's new equalization program***

It's called the RFPS – 'representative five-province standard', a result of the 1982 renegotiation process.

A key feature of the representative five-province standard is, of course, the new STANDARD.

'A province's revenues from each revenue source are raised to the level obtained by applying the national average tax rate to the average per capita base of the five provinces considered to be representative of all provinces. These five are Ontario, Quebec, British Columbia, Saskatchewan, and Manitoba.'

### ***Challenging the five-province standard***

The author believes that high on the reform agenda will be a questioning of the new five-province standard, and that concern will likely centre around two issues.

'The first relates to those theoretical features of the new program that lead to situations in which a change in a province's position can result in either an increase or a decrease in equalization, depending on whether the affected provinces are in or out of the standard. The second issue relates to the 'non-representative' nature of the new standard when it comes to resource rents. This issue will come to the fore when 'have-not' provinces begin to be assessed 100 per cent-plus 'tax rates' on their increases in resource revenues.'

### ***Prospects for the 1987 federal-provincial climate***

Throughout the 1970s and the early 1980s, concern about energy dominated the federal-provincial calendar, at least with respect to equalization.

Energy issues are not going to loom as large in 1987.

Professor Courchene explains, 'For one thing, the NEP now gives the federal government a larger share of overall energy revenues. For another, the domestic price of energy is now much closer to the world price than it was when the 1982 arrangements were being negotiated. Finally, and probably most important, the RFPS formula is relatively immune to major swings in the energy revenues of the resource-rich provinces.'



This study suggests that a NEW resource issue will probably come to the fore: the interaction between equalization and the resource revenues of 'have-not' (as distinct from 'have') provinces.

'For "have-not" provinces that are not part of the five-province standard, the RFPS levies, at best, a 100 per cent tax on any increase in resource rents. What this implies is that any deal that Ottawa and Newfoundland might strike with respect to offshore energy sharing would essentially be irrelevant, since Newfoundland's portion would be taxed away fully until the rent exceeded the province's equalization entitlement (whereupon the tax would fall to zero). Everyone agrees that as provinces become richer their equalization should fall. But for political as well as economic reasons confiscatory taxes can, in general, never be implemented. Thus, *the energy-related issue in the 1987 negotiations will be the manner in which the development prospects of 'have-not' provinces relate to the formula.*'

*There are two other factors that could affect the 1987 climate.*

The first is *the role of the established programs.*

'The federal decision in 1982 to withdraw from EPF the funding associated with the revenue guarantee constituted, in the eyes of many provinces, one of the most flagrant violations ever of cooperative federalism.'

There are also other ways in which Ottawa's recent concern with accountability and visibility could once again heighten federal-provincial tension. The author says, 'The provisions of the Canada Health Act that effectively reconditionalize parts of the established program funding could be carried farther afield. Moreover, the forthcoming report of the Macdonald Royal Commission is likely to make recommendations that will challenge the status quo with respect to both the division of powers and the federal-provincial institutional framework. This, too, could be a factor in the 1987 renegotiations.'

Professor Courchene continues by saying *a third and related factor that will likely influence the next set of negotiations, fiscal restraint, will probably be the order of the day.*

'There are two points to be made here. One is straight-forward – namely, that the monies available for federal-provincial transfers will surely fall short of provincial



demands. In times of overall restraint, the renegotiation of financial transfers is bound to be fraught with tension. The second point is more complex. Recall that during the 1982 renegotiations the federal government argued that it was bearing too much of the overall deficit in the system and that, as a result, established program funding should be reduced. Indeed, one of the arguments used by Helliwell and Scott in recommending their interprovincial revenue-sharing pool to 1981 Parliamentary Task Force was that the fiscal 'surplus' was now located at the provincial level. *Essentially, the underlying issue for the next set of negotiations is the following: which level of government will have the relative fiscal surplus in 1990? In other words, which expenditure categories are likely to expand over the next ten years? How will the aging of the population affect the growth of health expenditures, for example?*

The author says that while one cannot forecast the 1987 climate with any degree of certainty, the number of potentially contentious issues does seem sufficient to guarantee that the fiscal arrangements will once again, be negotiated in a tension-ridden environment.

### ***Recommendations regarding the bargaining process***

Professor Courchene notes that it appears the provinces, individually and collectively, remain very much passive observers between the five-year reviews and then become aroused, often passionately so, when the federal government unveils its proposals for the next set of arrangements. Typically, this is far too late in the day for them to have much impact.

He says it seems desirable that the provinces improve their ability to have substantial input into the renegotiation process. To this end, he recommends that *the provinces establish an 'Interprovincial Fiscal Secretariat'* that would play a fact-finding and research role on a continuing basis with respect to the fiscal arrangements; it might also be called upon to play either a leading or ancillary role in the deliberations leading up to the next set of fiscal arrangements.

### ***Conclusions by the author***

'It is tempting at the conclusion of any study to draw together the various strands of the analysis in order to build a better mousetrap, as it were. Unfortunately, or perhaps fortunately, I do not believe that there is a single best approach to the



design of Canada's equalization program. To put the matter differently, there are many rationales for equalization—economic, political, historical, and now, constitutional—and no one version of equalization is likely to come out on top on all of these counts. And even if one did, there is no guarantee that five years hence it would continue to maintain its pre-eminence. This much is amply evident from the historical evolution of equalization. Moreover, the various references in the course of the study to the ways in which other federations handle equalization also lend support to the notion that there is no such thing as a universal approach to equalization: the West Germans have implemented the equivalent of an interprovincial revenue-sharing pool, the Australians have adopted a fiscal-need approach, and the Americans have no formal equalization system at all.

...it is probably not an overstatement to assert that equalization has become an essential part of the glue that binds us together as a nation. The enshrining of equalization in the Constitution Act of 1982 reflects the place that equalization has come to occupy in the political and economic life of the federation. However, *there are storm clouds on the horizon.*

*The 1987 revision of the fiscal arrangements will certainly be tension-ridden.*

Established program transfers will again be a source of contention given the implications of the Canada Health Act and of the politics and economics of fiscal restraint. The RFPS is probably headed for considerable reform, given its obvious deficiencies. But overshadowing any specific concerns relating to the RFPS formula is the Ottawa-Nova Scotia offshore-energy deal, which will override whatever equalization program happens to be in force when these revenues come on stream. *The possibility of a movement of Canada's equalization program away from a formula-based system to a province specific system cannot be discounted if the offshore arrangement is generalized. There is no doubt in my mind that this possibility presents the most severe challenge in the history of Canada's equalization program and that because of it, the 1987 arrangements will represent a watershed in the evolution of the program.*

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*Equalization Payments: Past, Present and Future*, 433 pages, price \$12.50, is available at the following outlets:

The Ontario Government Bookstore, 880 Bay Street, Toronto, to those shopping in person. Out-of-town customers may write: Publications Section, Fifth Floor, 880 Bay Street, Toronto, Ontario, M7A 1N8, or telephone 965-6015 (toll-free long distance, 1-800-268-7540; in northwestern Ontario, 0-Zenith 67200). A cheque or money order, payable to the Treasurer of Ontario, must accompany all mail orders.

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